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Hiding the Ball-Transparency, Tax Law and the U.S. As the World's Favorite Tax Haven

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CHAPTER 3

"Hiding the Ball"—Transparency, Tax Law, and the U.S. as the World's Favorite Tax Haven

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Synopsis

§ 3.01 INTRODUCTION

[1] The Problem

Since the "Panama Papers" leak of 11.5 million documents (and the later "Bahama Leaks") highlighting how opaque entities were used for potentially shady purposes, governments around the world have been announcing stronger anti-avoidance efforts to force the disclosures of the identity of the beneficial owners of financial assets. The efforts are aimed at the use of nontransparent entities for both illicit offshore financing activities (e.g. terrorist networks), as well as for tax avoidance or tax evasion purposes. These materials will focus on the latter, although as the U.S. experience relating to foreign bank account reporting (FBAR) illustrates, measures originally intended to uncover illicit financing activities can become a powerful tool for exposing potential tax wrongdoing.

The discussion that follows will focus primarily on the use of the United States as a "tax haven" destination for the ownership of financial assets by non-U.S. persons. Tax haven as used herein refers to the legal landscape that enables individuals to hide information about their assets through nontransparent entities, rather than a reference to favorable tax rates or laws. As noted by one commentator, the United States, while chasing its own taxpayers, provides a nice haven for foreigners.[1]

It must be acknowledged that non-U.S. persons may want to avoid reporting of their ownership of these U.S. investments for perfectly legitimate reasons, including privacy and personal security. In addition, there are a number of legitimate reasons for money

[1] Lee Sheppard, "The United States as a Tax Haven" Tax Notes (9/19/16).

flow to the United States, including: safety and security from geopolitical risk; a stable legal system; a vibrant economy; and strong real estate markets in urban areas.

Nevertheless, governments are increasingly seeking to lift the cloak of anonymity from these investors. This paper will explore the current disclosure (anti-avoidance) landscape, both in the United States and other countries, with the goal of understanding why "The World's Favorite New Tax Haven Is the United States."[2] This will require a discussion of the growing trend toward regulatory requirements involving the identification and disclosure of the beneficial owners of entities. The focus in the United States will be on the recent efforts by The Financial Crimes Enforcement Network (FinCEN), as well as the Treasury Department and the Internal Revenue Service (IRS). These efforts reflect a concern by the U.S. government that individuals using assets from abroad may be investing the proceeds of illegal activity in entities created in the United States without having to disclose the identities of natural persons who are behind those entities. This concern has been heightened by the dramatic influx of foreign investments (and foreign financial institutions) into such locations as Wyoming, Nevada, and Delaware where shell companies can be easily and cheaply registered with no requirement to disclose the beneficial owner of the entity.

Outside the United States, the focus will be on various efforts by the Organization for Economic Co-operation and Development (OECD), including the OECD's Common Reporting Standard (CRS) requiring the automatic exchange of information by beneficial owners of financial accounts.

A related issue to this disclosure trend is the potential exposure to the lawyers, accountants, and other professionals who advise these non-U.S. clients. These professionals will have increasing obligations to act as "gatekeepers" with regard to the source and nature of their clients' funds being invested in the United States. These obligations will be imposed by a combination of moral, ethical, and legal considerations, including in certain cases potential criminal prosecution.

[2] The Press

This problem has not gone unnoticed by the mainstream press. A sampling of newspaper and magazine articles discussing the topic include:

- *The World's Favorite New Tax Haven is The United States*, Bloomberg Business Week (01/27/16)
- *How Anger Over Tax Havens Has Moved from Margins to Mainstream*, Financial Times (04/07/16)
- *Need to Hide Some Income? You Don't Have to Go to Panama*, New York Times, (04/08/16)

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[2] Bloomberg Business (1/27/16).

- *The Geography of Financial Secrecy,* The Atlantic (04/09/16)
- *"Tightening the noose,"* Financial Times (7/12/16)
- *Rinse Cycle: Do Lawyers Enable Money Laundering?,* Bar Talk, The American Lawyer, September 2016
- *Law Firms' Accounts Pose Money Laundering Risk,* Wall Street Journal (12/26/16)

§ 3.02 THE CURRENT DISCLOSURE (ANTI-AVOIDANCE) LANDSCAPE

[1] The United States

[a] FinCEN

Control over a number of U.S. rules concerning ownership and reporting of investment assets rests not with the IRS but with Treasury's FinCEN, which recently has focused on two specific scenarios: the purchase of high-end real estate and the opening of financial accounts.

[i] High-End Real Estate

In January 2016, FinCEN issued two geographic targeting orders (GTOs) aimed at combating money laundering in all-cash real estate transactions in Manhattan and Miami-Dade County, Florida. The GTOs, which took effect in March 2016, require title insurance companies to identify the actual persons behind entities using cash to purchase properties with a sales price of more than $1 million in Miami-Dade County and more than $3 million in Manhattan.

To comply with the orders, when completing FinCEN Form 8300, title insurance companies must:

- Identify the purchasing entity's beneficial owners, defined as each individual who owns 25% or more of the entity's equity;
- Retain a copy of each beneficial owner's identification document (e.g., passport, driver's license, etc.);
- If the purchaser is an LLC, provide each member's name, address, and taxpayer identification number; and
- Provide details about the transaction, including the property's address, purchase price, and the transaction's closing date.

Later in 2016, FinCEN expanded the January GTOs to cover high-end real estate purchases in California and Texas in addition to New York and Florida. These GTOs took effect on August 28, 2016, and will last for 180 days (through February 23, 2017). In practice, they also extend the validity of the original 180-day January GTOs to February 23, 2017.

As these GTOs indicate, FinCEN is serious about implementing the tools at its disposal to target money laundering as well as to more generally increase scrutiny of high-priced real estate transactions.

[ii] Customer Due Diligence Rules

On May 11, 2016, FinCEN issued the final version of its long-awaited "Customer Due Diligence Rules."[3] Previously, anti-money laundering (AML) regulations did not require financial institutions to identify the individuals that own or control their legal entity customers. The final rules impose a new requirement on "covered financial institutions"—which include, inter alia, banks, broker dealers, and mutual funds—to identify the beneficial owners who own or control certain legal entity customers at the time a new account is opened. The final rules are effective July 11, 2016, and covered financial institutions must comply with them by May 11, 2018.

"Legal entity customers" include a corporation, a limited liability company, or other entity that is created by the filing of a public document with an appropriate state office, a general partnership, and any similar entity formed under the laws of a foreign jurisdiction.

For each new account that a legal entity customer opens, the covered financial institution must identify its beneficial owner(s) under either of the following criteria:

- Each individual, if any, who directly or indirectly, through any contract, arrangement, understanding, relationship or otherwise, owns 25 percent or more of the equity interests of the legal entity customer (the "ownership prong"); or
- A single individual with significant responsibility to control, manage, or direct a legal entity customer, including an executive officer or senior manager (such as a Chief Executive Officer, Chief Financial Officer, Chief Operating Officer, Managing Member, General Partner, President, Vice President, or Treasurer), or any other individual who regularly performs similar functions (the "control prong").

The number of individuals that satisfy the definition of "beneficial owner," and therefore must be identified and verified, may vary. Covered financial institutions must identify at least one individual as a beneficial owner under the control prong for each legal entity customer and, depending on the ownership structure of the legal entity, covered financial institutions may identify zero to four individuals under the ownership prong. If a trust owns, directly or indirectly, 25 percent or more of the equity interests of a legal entity customer, the beneficial owner for the purposes of the ownership prong is typically the trustee.

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[3] 81 Fed Reg 29397 to be codified at 31 CFR Parts 1010, 1020, 1023, 1024, and 1026 (RIN1506-AB25).

Despite their breath, the new rules have significant gaps. The rules do not sufficiently capture those who can control an anonymous company because the definition of control conflates senior management and executive officers of corporate entities with the beneficial owners. Officials named in leadership positions can be figureheads with real control exercised through other means. In addition, the rules do not extend the requirement to collect beneficial ownership information to accounts established before the rules applicability date, creating a major gap in information collected. And finally, under the new rules, the beneficial owner of a trust under the ownership prong is the trustee, who is typically only the legal rather than beneficial owner of the trust's assets.

[b] Treasury and the IRS

Two significant tax developments in the disclosure and anti-avoidance area are the proliferation of reciprocal Inter-Governmental Agreements (IGAs) entered into pursuant to of the Foreign Account Tax Compliance Tax Act (FATCA) and the promulgation of final regulations that treat a domestic disregarded entity (DRE) wholly-owned by a foreign person as a domestic corporation separate from its owner for the limited purposes of the reporting, record maintenance, and associated compliance requirements under Section 6038A of the code. Finally, no discussion of this topic would be complete without at least a brief description of the U.S. government's exchange of information programs, including income tax treaties and Tax Information Exchange Agreements (TIEAs).

[i] FATCA

FATCA, as most tax professionals now know, is the U.S. enactment requiring non-U.S. financial institutions to provide identification of U.S. persons holding accounts (including interests in offshore alternative investment funds) in those foreign financial institutions. Although FATCA was initially designed as a one-way street to provide information to the U.S. on foreign financial assets held by U.S. persons, the signing of a number of reciprocal IGAs, in effect, required the U.S. to give certain financial information relating to residents of the partner jurisdiction to its tax authorities. On October 2, 2015, the U.S. began providing financial information to certain reciprocal IGA partner jurisdictions pursuant to the automatic exchange of information provided for in their jurisdiction's reciprocal IGA.

FATCA, however, is asymmetrical in its application and information the U.S. agrees to provide to the partner jurisdiction of a reciprocal IGA is much less than the U.S. obtains under the IGA.

Current law does not require U.S. financial institutions to report the same scope of information required of foreign financial institutions under FATCA. For example, FATCA requires the reporting of account balance or value of all financial accounts, whereas the United States generally only collects information on the U.S. source income paid to those accounts. An Obama Administration Budget Proposal would, however, require the reporting of account balances to reciprocal IGA partner jurisdictions.

At present, the U.S. will, in effect, not give its reciprocal IGA partners information pertaining to the following:

- Depository (i.e. cash) accounts held by entities, even entities resident in the IGA partner jurisdiction;
- Non-cash accounts, whether held by individuals or entities, even those that are resident in the IGA partner jurisdiction, *unless* the accounts earn *U.S. source income*, or
- The controlling persons of any entities, whether the entities are from the reciprocal partner jurisdiction or from third countries, and even if those entities are owned and controlled by residents of the reciprocal partner jurisdiction

[ii] Domestic Disregarded Entities

The Treasury has enacted final regulations that would treat a domestic disregarded entity owned by a foreign person as a domestic corporation separate from its owner for the limited purposes of the reporting, record maintenance, and associated compliance requirements that apply to 25 percent foreign-owned domestic corporations under Section 6038A.[4] The preamble to the regulations notes that these changes are intended to provide the IRS with improved access to information in order to allow it to satisfy its obligations under treaties and other international agreements such as reciprocal IGAs. The regulations would be effective for tax years beginning on or after January 1, 2017, and ending on or after December 31, 2017. If the foreign owner of a domestic DRE files a US tax return, the domestic DRE will have the same taxable year as the foreign owner. If the foreign owner does not have a U.S. tax filing obligation, the domestic DRE default to having a calendar year.

The consequence of the regulations is that the DRE would be required to file a Form 5472 information return with respect to reportable transactions between the entity and its foreign owner or other foreign related parties. By virtue of this requirement to file a Form 5472, the DRE would need to obtain an "employer identification number" from the IRS. In addition, the proposed regulations specify an additional "catch all" reportable category of transactions not already covered by another reportable category. The significant penalty provisions associated with failure to file Form 5472 and failure to maintain records would apply to the DRE.

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[4] TD 9796.

[iii] Exchange of Information Programs[5]

Exchange of information in this context refers to the sharing of tax-related information between two or more countries for tax administration and enforcement purposes. Exchanges of tax-related information between countries generally occur under the provisions of international tax information sharing agreements, including, inter alia:

- Income tax treaties—Tax treaties are intended primarily to prevent double taxation of income from international economic activity in two jurisdictions. Most treaties, however, include articles authorizing the exchange of tax-related information between the partner countries. Typically, the exchange is initiated by a request submitted by the foreign government but treaties may also provide for automatic or "routine" exchanges, such as the transmission of reports of taxes withheld from income paid to a nonresident alien.
- TIEAs—The sole purpose of these bilateral agreements is to facilitate the exchange of tax related information between partner countries. Despite being touted as the remedy for the offshore tax information deficit, TIEAs, in practice, often provide little useful information since they typically involve a slow, largely ineffectual, resource-intensive process in order to obtain the tax information requested.

[c] Legislation

The release of the "Panama Papers" focused the spotlight on several U.S. states—Nevada, Wyoming, and Delaware in particular—as havens for anonymous ownership of financial assets by virtue of the fact that those states do not require the disclosure of the beneficial owners of corporations formed under the laws of those states.

While meaningful legislation by any of these states requiring disclosure of beneficial ownership is remote, the Wyoming Secretary of State's office is investigating M.F. Corporate Services Wyoming, LLC, a registered agent for Mossack Fonseca, the law firm at the center of the Panama Papers leak. Nevertheless, the Wyoming secretary of state's office has publicly announced its opposition to renewed calls for the release of beneficial ownership information for entities formed in the states.

On the federal level, bipartisan legislation requiring the disclosure of beneficial owners at the time of incorporation has been introduced (and not passed) in every congressional session since 2008. Most recently, "The Incorporation Transparency and Law Enforcement Assistance Act" was introduced in early 2016 in both the House and

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[5] See IRS LB&I International Practice Series, Overview of Exchange of Information Programs.

Senate (H.R. 3331; S. 1465). In addition, the Obama Administration has announced that Treasury is sending draft legislation to Congress requiring legal entities to know and report information on beneficial ownership.

[2] The Rest of the World

[a] CRS

Under an OECD-led initiative, agreed in 2014, by 2018, the 96 jurisdictions that have adopted CRS will be automatically exchanging information on the details of individuals' bank accounts and trusts. An exchanging jurisdiction must, however, enter into a bilateral agreement with each jurisdiction with which it intends to exchange information. By the end of 2016, there were 1,300 bilateral relationships in place across the globe. Although broadly modeled on the FATCA concept of outsourcing tax enforcement to foreign asset managers, CRS differs in important respects, including:

- Unlike FATCA, CRS often compels the reporting of nonfinancial assets, as well as on details of the ownership structures themselves, including not only the ultimate owners of the assets, but also the ultimate owners of entities that don't own anything—for example, trustee or protector companies.
- CRS is concerned with tax residence, a more nebulous concept than U.S. person
- CRS imposes no withholding penalty, instead relying on reciprocity and penalties in each implementing country, as well as the threat of licensing withdrawals for defaulting banks or other intermediaries.

Because the United States has not signed on to CRS (i.e. is listed as a nonparticipating jurisdiction) and is unlikely to sign on in the near future, this CRS "loophole" is clearly a factor in driving foreign assets to the United States.[6] By virtue of the anonymity of beneficial ownership of corporations formed in many U.S. states (discussed previously) and the non-participation of the United States in CRS, the United States has become the World's Favorite New Tax Haven.[7]

[b] United Kingdom, Crown Dependencies, and Overseas Territories International Tax Compliance Regulations (UK CDOT)

In 2014, the UK government finalized Inter-Governmental Agreements (IGAs) with the Crown Dependencies and Overseas Territories as part of their commitment to

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[6] For a detailed discussion of this and other CRS loopholes, see Mark Morris, "The 24 OECD Common Reporting Standard Loopholes" (1/12/17).

[7] Peter A. Cotorceanu, "Hiding in plain sight: how non-U.S. persons can legally avoid reporting under both FATCA and GATCA [CRS]," Trusts & Trustees, December 15, 2015.

combat tax evasion by UK residents. Following these agreements, Financial Institutions became required to identify tax residency of all clients with accounts in jurisdiction covered by the regulation. This specifically impacts clients with accounts in London and Jersey. UK CDOT was a pre-cursor to CRS.

[c] Beneficial Ownership Registers

The driver for establishing beneficial ownership registers comes from the G20 High-Level Principles on Beneficial Ownership Transparency adopted at the G20 Summit in 2014. The G20 particularly stressed the importance of countries and jurisdictions improving the availability of beneficial ownership information to, and its international exchange between national tax authorities. In 2016, the Finance Ministers of the G5 countries wrote to the other G20 Finance Ministers proposing a system of global interlinked beneficial ownership registers.

To date, both the United Kingdom and the European Union have implemented public registers. Other jurisdictions, such as the Cayman Islands, have met the same obligation by insuring that their regulatory bodies have the information available from the formation of the relevant entities and that valid requests for information will be responded to in a timely fashion. The United States, to date, has no announced plans for such a national beneficial ownership directory.

[d] EU Parliament's Panama Papers Committee

In December 2016, the EU Parliament's Panama Paper's Committee released a Working Document on the inquiry into Money Laundering, Tax Avoidance, and Tax Evasion. The working Document stated:[8]

> "The co-rapporteurs are of the opinion that the practices revealed by the Panama Papers shed light on unacceptable levels of secrecy, allowing for tax evasion, tax avoidance and money laundering both inside the EU and globally. . . . It is the belief of the rapporteurs that the EU, as an economic leader, must lead by example by maintaining the highest transparency standards and by forcing other financial centres to comply with global and European transparency standards."

The Working Document stated the Committee's intent to look further into the roles played by different intermediaries in setting-up of offshore constructions, including financial institutions as well as lawyers representing clients in assisting in setting up offshore constructions. The Committee indicated that it intends to explore how common it is for lawyers to provide assistance in assuring anonymity for their clients.

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[8] "EU Panama Papers Panel Issues Working Paper Ahead of Meeting," Tax Notes Int'l (12/15/16).

§ 3.03 THE ROLE (AND RISKS) OF GATEKEEPERS IN THE NEW WORLD OF TAX TRANSPARENCY

[1] Circular 230

In the new world of tax transparency and the worldwide hunt for the elusive "beneficial owner," lawyers and accountants advising foreign clients will have increasing obligations to act as "gatekeepers" with regard to the source and nature of their client's funds being invested in the United States. These obligations will be imposed by a combination of moral, ethical, and legal considerations.

A question that is often asked is whether a tax advisor can continue to rely solely on the information supplied by a client. Under Treasury Department Circular 230, a practitioner cannot rely on a client's information when that information is inconsistent or incomplete on its face, or inconsistent with other information known to a practitioner. In other words, the advisor cannot turn a blind eye to apparent inconsistencies and gaps in the client's story.

[2] Criminal Exposure

The U.S. Government's next wave of criminal enforcement activities has started to focus on investments made in the United States to evade foreign taxes. Increasingly, the governmental tools used to fight terrorist financing will be utilized to fight financial secrecy and tax evasions. Of particular concern is the potential criminal exposure of both the client and the gatekeeper under a number of criminal law theories, including mail, wire, or bank fraud, which may be charged in a tax case.

Gatekeepers should be aware of the following concerning their potential criminal exposure:

- The doctrine of "willful blindness" is often invoked in tax cases to create criminal liability when a tax advisor is accused of having looked the other way. This doctrine does not require intent, it simply requires that the advisor failed to investigate what he or she should have.
- Tax Division Directive No. 128, which discusses the circumstances under which mail, wire, or bank fraud may be charged in tax cases;
- Pasquantino v. United States 544 US 349 (2005), a Supreme Court decision holding that a scheme to smuggle liquor from the United States into Canada to avoid Canadian taxes constituted a wire fraud scheme, because Canada's right to the uncollected taxes qualified as "property" within the meaning of the wire fraud statute;
- The forfeiture complaint in the Wegelin bank prosecution,[9] an offshore

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[9] http://www.justice.gov/usao/nys/pressueleases/april12/wegelinforfeiture.html.

tax case in which a money laundering/mail and wire fraud theory was used as the basis for forfeiture;

- On October 31, 2016 the Manhattan US Attorney charged six individuals for their role in an international money laundering scheme involving over $100 million. Defendants transferred funds through dozens of shell corporations in the United States and Mexico as part of a scheme to fraudulently obtain tax refunds from the government of Mexico. The US Attorney supported the indictment by citing the Pasquantino case.

[3] Law Firm Client Accounts

The Financial Action Task Force (FATF) is targeting law firm client accounts as a real area of concern. On December 26, 2016 *The Wall Street Journal* reported that "tens of billions of dollars every year moved through opaque law firm bank accounts that create a gap in US money laundering defenses." The Journal states that this is achieved by law firms lumping together clients' money that they are holding for short periods in escrow accounts and the law firms face no requirement to disclose whose cash is in the accounts. Generally the account is opened only in the name of the law firm. Money stays in these accounts sometimes only for a few days or weeks and at the request of the firm's clients' funds can be sent to other parties with very little transparency. While banks and other firms that move money across borders face heavy pressure to alert regulators to suspicious activities, US law firms protect the confidentiality of pooled accounts in the name of attorney-client privilege, with the result of a way of getting money into the US system without going through the anti-money laundering safeguards that generally apply.

[4] Lawyers' Fees

U.S. Attorney's Manual 9-105.600 discusses the prosecution of attorneys for the receipt and deposit of attorney fees allegedly derived from a specified unlawful activity. Criminal Resource Manual 2012–2014 elaborates on aspects of U.S. Attorneys' Manual 9-105.600, in particular, by examining what constitutes bona fide fees, what constitutes actual knowledge, and what evidence may be relied upon to meet the knowledge requirement of the policy.

[5] Foreign Bank Records

Proposed legislation has been introduced to permit the issuance of subpoenas to foreign banks inside the US. This proposed legislation would amend 51 U.S.C. 5318(k)(3) to allow law enforcement authorities to access foreign business records by serving bank branches located in the United States regardless of bank secrecy or data privacy laws in the bank's home jurisdiction. The proposed amendment will enhance the ability of US investigators to obtain overseas bank records as a form of legally admissible evidence.

§ 3.04 CONCLUSION

As detailed in the report "Overcoming the Shadow Economy" authored by Nobel prize winning economist Joseph Stiglits and Swiss anti-corruption expert Mark Pieth, the U.S. and Europe must eliminate the secrecy havens in their own backyard before they can force other financial centers to comply with global transparency standards. This article reviews the worldwide actions taken to date in regard to tax transparency in relation to the ownership of financial assets but, as is clear from this discussion, they are merely preliminary steps toward that laudable tax policy goal.